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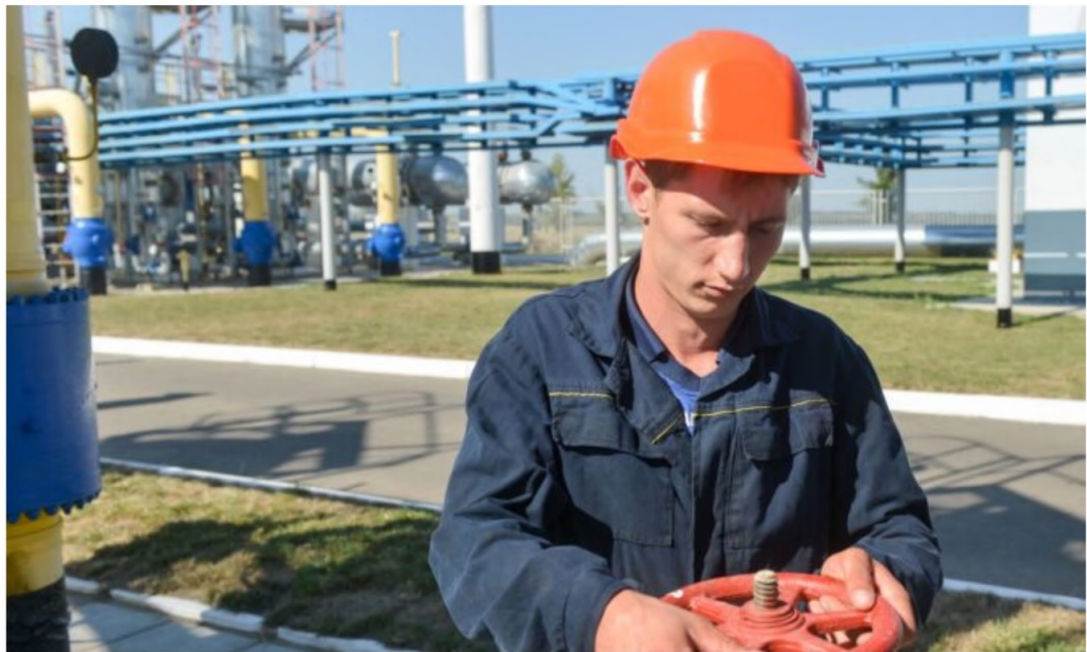
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An employee works at a compressor station of Ukraine's Naftogaz national oil and gas company near the northeastern Ukrainian city of Kharkiv on August 5, 2014. (SERGEY BOBOK/AFP via Getty Images)

BUSINESS

Success in Ukraine Energy Company: Less State Intervention and Zero Tolerance for Corruption

BY ELLA KIETLINSKA | March 20, 2020 Updated: March 22, 2020 Text size Print

Crisis on Gas Supplies, Deliveries to Europe



Since 2014, when

[Andriy Kobolyev](#) was appointed

as CEO of state-owned Ukrainian oil and natural gas

[company Naftogaz](#)

, the company has

turned

around annual losses of \$6.5 billion to annual profits of \$8.5 billion, accounting for 8 percent of the country's revenue.

That success can be attributed to a new business model implemented by the new management team under Kobolyev's leadership, he explained during an [interview](#) at the Atlantic Council on March 3. The change helped the company to break its dependency on Russian gas, which was sold at prices above fair market price.

Previously, deals between Russia and [Ukraine](#) had been handled by intermediaries, which contributed to [corruption](#). In addition, gas produced domestically was heavily subsidized by the state and sold at cheap prices, also creating opportunities for corruption, and preventing incentives for consumers to use it efficiently. Kobolyev said that Ukrainian gas consumers would use three to four times more gas than people in comparable Eastern European countries.

Kobolyev and his team managed to diversify gas sources through making deals with European suppliers and improving energy efficiency, as well as changes to management practices in the firm, thus making the company profitable.

He said further improvement will be achieved in May, when the Ukrainian government repeals the obligation to sell gas through intermediaries in order to comply with a requirement set by the International Monetary Fund (IMF). This will allow Naftogaz to sell gas directly to households, Kobolyev said.



Andriy Kobolyev, CEO of Naftogaz, speaks to reporters outside the government building in Kyiv, Ukraine, on June 16, 2014. (AP Photo/Sergei Chuzavkov)

When asked about measures that could be taken by other large state-owned enterprises that want to replicate Naftogaz's success, Kobolyev said that the key to his company success was corporate governance reform. The most success can be achieved when the state doesn't intervene in company operations and governance, he said.

If the "state intervenes then the result is significantly less

if the state intervenes then the result is significantly less attractive, ... less profitable, or less value-creating and that was the main reason why Naftogaz managed to succeed,” Kobolyev said.

Kobolyev was also a proponent of a long-term plan to privatize Naftogaz, the strategy approved by the former Ukrainian government, and believed that this strategy should be applied to “all major enterprises which don’t have strategic impacts on vulnerable areas of the economy.”

Another factor that significantly contributed to the Naftogaz success was “zero tolerance for corruption,” according to Kobolyev.

Naftogaz Deal With Russia’s Gazprom

Naftogaz **signed** a 5-year **deal** with Russian state-owned company Gazprom ensuring uninterrupted transit of Russian natural gas to Europe on Dec. 30, 2019. The agreement requires Gazprom to ship 65 billion cubic meters (bcm) of gas to Europe through Ukraine in 2020—22 bcm **less than** Gazprom transited in 2018—and 40 bcm annually over the following four years.

Gazprom has also paid Naftogaz \$2.9 billion awarded by the Stockholm arbitration court, which, together with additional interest and back payments, amounts to about \$5 billion, said Michael Carpenter, managing director of the Penn Biden Center for Diplomacy and Global Engagement

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“Adoption of the European Union’s Third Energy Package legislation is enabling Ukraine to charge market-based rates for its transit services and to include a ‘pump or pay’ clause, which commits Gazprom to pay the transit fee if the agreed-upon minimum volumes are not pumped through Ukraine’s system,” Atlantic Council Associate Director Olga Khakova said in a [report](#).

Carpenter emphasized that the agreement “is not a ‘take or pay’ [clause](#)”—the Russian company is obligated to send a certain volume of gas through Ukraine to its European customers regardless of how much is used—guaranteeing Ukraine at least \$7 billion in transit fees.

In return, Naftogaz agreed to “drop most of the claims and assets that it was seeking to attach or freeze ... in various parts of Europe, with the exception of claims that Ukraine maintains to stolen properties in illegally annexed Crimea,” Carpenter said.

The transit volume was a [compromise](#), but for Ukraine, the agreed volume is better than expected due to the sanctions imposed by the United States on the construction of the Nord Stream 2 pipeline. Nord Stream 2, a gas pipeline under the Baltic Sea running directly from Russia to Germany, was expected to go online at the end of 2019.

Due to the U.S. sanctions, the completion of Nord Stream 2 will be significantly delayed, possibly for at least a year, according to Carpenter.



General view of Russian natural gas giant Gazprom's headquarters in Moscow. (Yuri Kadobnov/AFP/Getty Images)

“All in all, it’s a great deal,” Carpenter said. “It is a compromise—nobody got 100 percent of what they wanted—but it is a great deal for Ukraine’s energy security.”

Atlantic Council Eurasia Center Director and former U.S. ambassador to Ukraine John Herbst said that it was foreseen in 2014 that Russia could potentially “use gas as a weapon in the winter of 2014–2015.” Kobolyev, together with his team, enacted “reforms to increase gas pricing to reduce overuse of gas and the great pressure on the budget coming from the gas sector.”

The company was also able to “get reverse [gas] flow from Europe” in addition to increasing its own gas production. All these achievements contributed to “the successful

All these achievements contributed to the successful negotiation of the gas deal with the Kremlin,” Herbst said, adding, “They did it precisely because the plans they were working on for several years came to fruition, and that’s the reality.”

Further Steps to Advance Ukraine’s Energy Security

“International institutions [could] help Ukraine’s new government finish the corporate governance reform,” since it’s unlikely for Ukraine to become prosperous or achieve energy independence “without corporate governance reform, without proper supervisory boards, without independent people who insulate state-owned enterprises,” Kobolyev said.

Increasing energy efficiency will also help, but it requires more investment, advanced technology, and skills, according to Kobolyev. While the government won’t be able to influence energy prices, promoting efficient energy

solutions will cause consumers' energy bills to decrease; that may translate into a political gain for the government.

Carpenter said during a panel discussion that the United States can help Ukraine become energy independent "with reforms to achieve energy efficiency." Wasteful consumption patterns of energy in Ukraine skews energy prices "and does not create an incentive to reduce" them, he said.

Naftogaz's success has inspired other Ukrainian state-owned and private enterprises to employ the same [anti-corruption](#) and transparency policies, said Kobolyev, who emphasized that there are two key factors critical in fighting corruption: "First, is there should be proper market compensation ... and second, is there should be rule of law."

Fighting corruption, along with "ensuring energy security," and "promoting market-oriented economic and governance reforms" is one the four major strategic objectives of United States aid to Ukraine, according to the U.S. Agency for International Development (USAID) strategic plan ([pdf](#)) for Ukraine for the years 2019 to 2024.

If Ukraine lowers its corruption level to that of its regional neighbors, its GDP could increase by 0.85 percent, according to the USAID strategic plan. The energy sector in Ukraine is one of four sectors with the highest level of corruption. The USAID program will support anti-corruption champions in Ukraine's state and local governments by promoting transparency, electronic

services, and replacing paper-based transactions with online electronic systems, political finance reform, and a dedicated anti-corruption court.

“What is very important is that people in Ukraine should be shown that not being corrupt is a pragmatic choice,” Kobolyev said. “Not some rosy unrealistic option, [but] that they will be better off not being corrupt.”

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